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How to make decisions about long-term investing

The frustrating reality of long term investing is that, because of ever-shifting market and manager vagaries, we simply cannot definitively say that one investment strategy is superior to another over all periods. That said, our clients look to us for answers as to which investment strategies best suit their needs.

We believe we have created a new framework that helps our clients understand that every investment choice involves trade-offs. But by clearly understanding which factors in the decision-making process resonate most loudly to trustees and their members, we can create a framework that not only establishes the right performance expectations for their solution, but clarifies how this performance can best be monitored and assessed. Effectively it provides trustees with insights as to what trade-offs are implicit in their choice.

How do Trustees *really* determine their investment strategies?
In 1999, a fascinating study of the decision-making behaviours of trustees globally concluded that trustees appear to place as much emphasis on non-financial reasons for selecting a specific strategy as they do on financial reasons. In fact, as the table below highlights, the split is fairly consistently around 50%/50%.[i]

Practitioners' views of financial and non-financial factors for selecting their investment strategy:

Balance of factors (%)	Australia	New Zealand	Japan	UK
Financial = Net information ratio	56%	50%	41%	54%
Comfort = SleepWell	21%	21%	28%	21%
Compatibility = SeemsGood	23%	29%	31%	25%

Source: Watson Wyatt Global Asset Study 1999. Data collected interactively from conference participants

What are these "non-financial" factors? The authors grouped these non-financial criteria into the ***Sleeps Well*** and ***Seems Good*** categories.

Sleeps Well decisions are ones trustees might be inclined to make just so they won't appear to be too different from other trustee boards. Decision-making behaviours such as using peer-group benchmarks, selecting only big brand investment managers, opting for excessively conservative strategies just so losses aren't incurred while the trustees are in power, are all behaviours that probably serve more to create a sense of security with trustees than necessarily address the financial requirements of members.

Seems Good decisions reflect the kind of cognitive errors that most human beings seem to fall prey to, such as the unwarranted confidence that trustees place on past performance, or the overconfidence we feel when we hear that managers seem have beaten their peers, or the temptation to make decisions on results that only occurred because of unique, time-specific conditions or manager top quartile rankings. These are phenomena that plague just about every industry – not just investments – suggesting that most human beings are ill-equipped to avoid them.

Indeed, the 50/50 split between financial and non-financial factors for trustee decision-making should not be too surprising. But being cognizant of it is ical if we want to keep ensure that clients stay committed to the long term objectives we set with them. More importantly though, if investors can understand the trade-offs that are implicit in a solution that incorporates both financial and non-financial factors, then they have a much more viable way to formulate meaningful performance expectations (both short term and long term) and then measure it.

Let's use a specific case in point:

Mapping Investment Strategies against a Trade-off Continuum

Perhaps where trustees become the most confused is about their mandate from their members: Is it to achieve the highest returns at a specified level of risk for their members? Or, is it to meet the long term funding requirements of their members with the view that these funds should be accessed **only** at retirement? These two objectives not only demand completely different investment approaches but they necessitate completely different approaches to monitoring and performance assessment. But non-financial factors will often lead to decision-making that muddles these two distinctly different objectives to the point that sub-optimal and often completely wrong investment decisions are made.

But, by mapping these two different objectives against our "trade-off continuum" of financial and non-financial criteria, we can derive some critical insights into what trade-offs we make for each decision and what impact that should have on our performance expectations.

The continuum has nothing to do with risk and return in the conventional sense. Rather it addresses how much we can assess in advance about potential performance outcomes and what factors contribute to our uncertainty around issues such as:

- our dependency on fund manager skill,
- our likelihood of being able to assess it,
- our ability to attribute where performance came from, and
- the certainty we have around how much return will cost us in any given strategy.

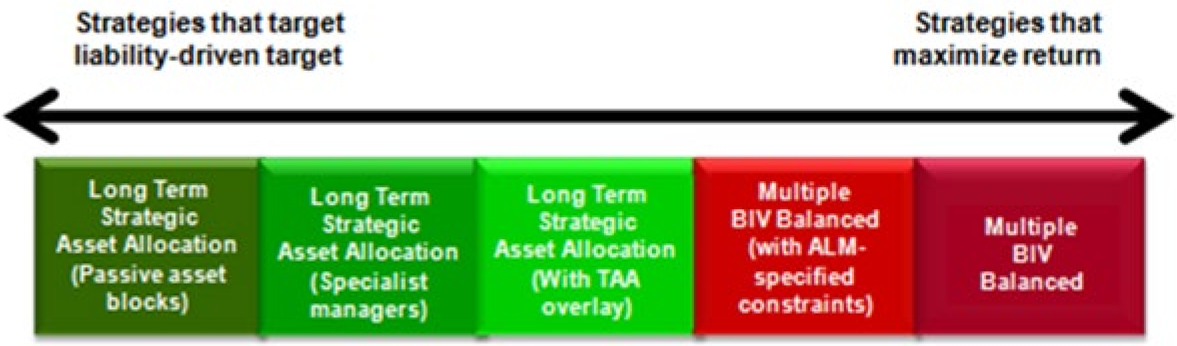
At the far left of the continuum are strategies that have been structured to have the highest probability of meeting specific liability-driven targets. For example, achieving specific Net Replacement Ratio targets over a 30 year period would be one such target. Providing a guaranteed return of CPI+2% over a three year period would be another such target.

Note that the objective is to meet the target – not necessarily beat the target. But just as such strategies are not likely to provide the highest possible absolute or even relative returns, they are also unlikely to dramatically underperform these funding targets.

At the far right of our continuum would be strategies that focus on simply achieving the highest return possible for the investor at some specified level of risk. Essentially this is the end of the continuum where asset managers employ no specific benchmark, claim to be benchmark agnostic – or employ "benchmarks" that reflect peer group comparisons of performance

The key point is that *any* investment strategy can be assessed along this "trade-off continuum".

The Trade-off Continuum for retirement fund investment strategies



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The critical insight though, is that wherever you have strategies where the benchmark is not investable or clearly identified in advance[ii] your ability to assess manager skill begins to deteriorate rapidly. As our table below highlights

Trade-off Continuum in balancing financial and non-financial criteria in strategy decision-making

Strategies that target funding requirements	Strategies that target maximum return
Higher probability of meeting a specific funding requirement Low variability around funding target Risk management means less dependency on manager skill Manager skill easier to assess but depends on solution Potentially lower cost but depends on solution Performance highly dependent on getting strategic asset allocation right Performance assessment *must* be against the long term funding target only.	Higher possibility of performance but less certainty about potential outcomes More dependence on manager skill Manager skill more difficult to assess Performance attribution difficult to assess Difficult to know in advance what cost will be incurred for outperformance Performance highly dependent on manager selection and mandates Performance assessments may be made against peer groups – although outcomes may not be a function of skill – nor are they related to a member's funding target

Note that what we ***are not*** saying is that one strategy is better than the other. Nor are we suggesting that there aren't skilful managers. We are simply trying to help our investors understand how they arrived at the investment strategies they did (the balance between financial and non-financial factors) and how the trade-off continuum can help them arrive those critical "reasonable expectations" as to what the chosen strategy can and cannot achieve.

[ii] For example, the drawback of peer group benchmarks is that asset managers cannot know their constituents in advance making them particularly difficult to outperform using a risk targeted strategy.